Capital Markets Monitor

March/April'03

Financial Attaché's Office
U.S. Embassy Moscow

CORPORATE GOVERNANCE UPDATE

The Institute of Corporate Law and Governance (ICLG) releases 4Q ratings

The Institute of Corporate Law and Governance (ICLG) updated its corporate governance core ratings for 25 companies. This rating system is based on several parameters, including transparency, shareholders' rights, corporate governance history, corporate risk, and capital structure. The Institute is a minority shareholder in each of the companies it rates and does not solicit fees for its ratings. The top score this year went again to Vimpelcom -- not surprising, given its level three ADRs and stellar disclosure practices. The ratings of Lenenergo, Tyumen Oil Company (TNK), and Moscow Telephone (MGTS) have improved considerably compared to Q3 2002, helped no doubt by their willingness to provide all information requested and an appropriate level of disclosure.

By contrast, LUKoil's rating dropped considerably, finishing 15th (down from 7th) because of its failure to provide any information requested. LUKoil commented that this must have been some kind of misunderstanding, as it is always receptive to requests from its shareholders. Slavneft's rating fell as well; the ICLG explained that the downgrade was due to uncertainty over the plans of the new owners of the company, which exposes minority shareholders to additional risks (See CMM for Dec.'02-Jan.03). For example, Slavneft's information disclosure has deteriorated since the merger, even taking into the account that it has never been very transparent to begin with. As for the overall annual results, Norilsk Nickel, Rostelekom, Aeroflot, Surgut and GAZ were rated highest for the year, while the ratings of Severstal and RAO UES fell slightly. The ratings for the next period will include information from the 2003 AGMs, as well as an indication of any changes in disclosure practices of other companies that were recently merged, for example Yukos and Sibneft.

A table indicating the core ratings follows:

Place in rating (3Q rating)	Company name	Final rating (%)	Chng in final rating (%)
1 (1)	Vimpelcom	84.12	-0.42
2 (4)	Norilsk Nickel	65.57	+0.21
3 (2)	RAO UES	65.15	-1.04
4 (3)	PTS (North-Western Telecom)	64.95	-0.41
5 (11)	Lenenergo	64.95	+6.81
6 (6)	Sibneft	62.47	-1.04
7 (5)	YUKOS	62.27	-2.06
8 (8)	Rostelecom	60.41	0.00
9 (9)	Kuzbassenergo	59.59	0.00
10 (10)	Gazprom	59.18	+0.42
11 (12)	Aeroflot	58.97	+0.83
12 (15)	Samaraenergo	56.08	+0.82
13 (16)	Irkutskenergo	55.05	+1.03
14 (18)	Moscow Telephone (MGTS)	54.64	+3.09
15 (7)	LUKoil	54.43	-6.19
16 (14)	Bashkirenergo	54.23	-1.23
17 (20)	Tyumen Oil Company	54.23	+4.75
18 (13)	Slavneft-Megionneftegaz	52.78	-3.71
19 (17)	Surgutneftegaz	52.37	-0.21
20 (19)	Severstal	50.72	0.00
21 (21)	Tatneft	46.19	-0.61
22 (22)	GAZ	45.36	+0.41
23 (24)	Avtovaz	44.95	+2.27
24 (23)	Volgatelecom	44.74	0.00
25 (25)	Rosneft- Purneftegaz	33.02	+0.21

*ICLG

RSPP, Chamber of Commerce, and FCSM Establish Corporate Governance Body

In late March, The Russian Union of Industrialists and Entrepreneurs (RSPP), the Chamber of Commerce and Industry, along with the Federal Committee on the Securities Markets (FCSM), established the National Council of Corporate Management (NCCM). It will include heads of Russia's largest corporations, including Vladimir Potanin of Interros, LUKoil's Vagit Alekperov, Rosgosstrakh's Ruben Vardanyan, Gazprom's Aleksey Miller, Yukos's Mikhail Khodorkovsky, and RAO UES's Anatoliy Chubais. RSPP head Arkady Volskiy indicated that the NCCM will analyze corporate management in Russia, suggest changes to legislation, create a national rating of corporate management, and adopt the Corporate Management Code. As a start, Deputy Minister of Economic Development and Trade Andrey Sharonov announced that the MEDT will review certain amendments, prepared by the NCCM, to legislation concerning corporate mergers and takeovers.

IPA Changes Focus from Independent Directorship to Shareholders' Rights

The Investor Protection Association (IPA), an organization dedicated to minority shareholders' rights and improving corporate governance in Russia, announced in late April that it intends to nominate 58 candidates for the boards of 43 Russian companies, and will be seeking the support of other minority investors for these seats. However, the number of companies for which the IPA intends to nominate candidates is lower this year, from 68 in 2002 to 43 in 2003, with an increased focus on utilities. Of the 58 candidates proposed, only 30% will run as "independent directors" -- down from 70% last year. Independent directors from the IPA normally coordinate their votes and share information about the firms with other IPA members. Instead, the majority of IPA candidates this year will be "representatives of minority shareholders," who are responsible mainly to the limited circle of shareholders whom supported their nominations. This change perhaps reveals a shift away from protecting investor rights more generally, and more towards protecting the interests of its members. This could reflect the fact that the IPA's membership in recent years has broadened from mostly portfolio investors to include brokers and other representatives of the securities industry.

REGULATORY UPDATE

Two proposals for regulation of futures - solution on the way?

Currently, the Russian futures market functions in a legal vacuum. Different segments of the market are regulated currently by FCSM, the Central Bank, and the Tax Code, but there seems to be a growing desire for a separate law to provide a coordinated and sounder legal basis for this market. In April 2003 the government proposed a new draft law "On Derivatives" for Duma consideration. The draft law defines derivative instruments and describes the general functioning principles of this market. Even though the draft has been heavily criticized, it is a positive first step towards filling the legal vacuum. A major deficiency of the draft is that it does not specify which government body will act as regulator, leaving this decision to the Ministers. This is a fundamental problem, which has already been the source of conflict between the FCSM and the Anti-Monopoly Ministry in other markets. Another problem that it is difficult to draft a law to cover all contingencies, especially in a market such as derivatives where innovations might be stifled by the law.

The State Duma has also addressed another major issue regarding futures: namely that futures are still considered by the Arbitrage Courts as gambling, which deprive market participants from legal protection in case of default. (See CMM for Sep.-Oct.2002). Currently, the Duma is considering amendments to Article 1062 of the Civil Code, prepared by the Committee on Credit Organizations and the Financial Markets. The authors attempt to define futures in a way that would be subject to legal protection. However, many Deputies have already noted that the definitions are somewhat vague and extend beyond financial markets, implying that the amendments need further development. At the same time, another group of Deputies from the same Committee has proposed an alternative set of amendments, proposing a separate Article called "On derivatives" to the Civil Code. Even though this has not yet been proposed for the Duma's consideration, the high level of debate on this issue, and its applicability to managing bank risk, makes it likely that a solution may be found soon.

Price Manipulation regulation in force

Curbing insider trading -- and the related problem of price manipulation -- are major goals of the FCSM to improve trust and confidence in Russian equity markets. The FCSM and Duma have heretofore hoped that a new law "On Insider Information", which has passed through a first reading in the Duma, would provide a legal basis to resolve this issue. However, the bill has not had a second reading due to major lobbying against it. Regulators are therefore attempting to address the problem from a different angle, namely implementation of FCSM regulations on price manipulation.

The term “price manipulation” was defined by specific amendments to the law “On the Securities Market," which were adopted at the end of last year. (See CMM for Dec.02-Jan.03). Price manipulation was defined as actions creating the appearance of a change in stock prices or volumes in order to provoke investors to buy or sell. Such actions include spreading false information, concluding transactions on the exchange without change of ownership, and agreeing to buy or sell shares at prices significantly differ from market prices. The same amendments give the FCSM the right to investigate cases of potential price manipulation, as well as to judge cases and punish violators.

Implementation of the new amendments to the law required a separate FCSM resolution, which came into force on April 12, 2003. The resolution establishes rules for tracing cases and conducting investigations. Grounds for investigations of possible violations could be reports from traders, clients and stock exchanges, as well as information from State Agencies or mass media. Investigations can last up to half a year, with the possibility of prolongation by two additional months. During an investigation, the Commission is allowed to request any additional information from the potential violator, including full information on any deals, data on the clients, analytical reports, etc. Many trading houses were unpleasantly surprised by the unprecedented maximum length for investigations and the almost unlimited right of the FCSM to access brokers' financial information. If a market participant is found guilty, he can face revocation or cancellation of his trading license.

Meanwhile, the FCSM has proposed to amend Article 185 of the Criminal Code to include the possibility of criminal punishment for price manipulators. Currently, the law specifies a prison term of up to five years, along with property confiscation, for inclusion of false information in prospectuses for new issuances, and for placement of shares without state registration. The newly proposed amendments also include punishment for the insider information usage, improper use of clients’ funds and violation of ownership rights registration in the registrars.

In order for the FCSM to track price manipulation, a computer system called Proteus has been introduced to the market. It is now being tested on the MICEX and RTS, and procedures are being developed to implement it fully. The system is able to trace unusual transactions based on an analysis of set parameters in the computer. In order for the system to work effectively, the FCSM needs to separate indirect (market) deals from direct (negotiated) deals. Direct deals are the ones that offer the greatest opportunities for price manipulation, and, according to preliminary FCSM data, around 30-90% of all deals during each month can be classified as direct. Based on the large number of direct deals in the RTS market, it is facing sanctions from the FCSM for failing to comply with regulations issued in July 2002 requiring the stock exchanges to separate direct deals from indirect ones. (See RTS News below).

The FCSM initiative is timely, as unfortunately price manipulation is a reality on the Russian market, and continues to scare off foreign portfolio investors. However, the Russian market is still very small and illiquid and is vulnerable to price shocks of any kind, which makes price manipulation hard to detect. For example, experts are divided as to whether the Surgutneftegaz price surge in April (see below), or the movements in Slavneft and Sibneft shares before their merger announcement were price manipulation or not, but the practice is widely assumed to occur without prosecution. Many market players realize the necessity of such a resolution, but are concerned about the possibility of substantially increased FCSM powers, along with what they consider a rather vague definition of price manipulation, which could conceivably lead to sanctions against the innocent.

FCSM Lowers Cap on New ADR Issuance

In mid-April, the Federal Commission on the Securities Markets (FCSM) issued a new regulation regarding the placement and the trade abroad of shares issued by Russian companies, now being reviewed by the Ministry of Justice. The regulation states that up to 5% of shares issued may be directly placed and traded on exchanges outside of Russia. Currently, these shares may only be traded as American Depository Receipts (at higher cost to issuers). Costs to issuing ADRs will increase further, as the regulation proposes more stringent requirements for new ADR issuances. Finally, the regulation would lower the cap on shares traded in ADR form from 75% to 40% of the total outstanding. While most Russian companies were comfortable with the 75% limit, the new 40% limit could complicate additional ADR share issues for companies where current ADR ownership is already high, such as Lukoil, Vimpelcom and OMZ.

CAPITAL MARKET EVENTS

RTS News and Problems

At the end of January, the FCSM claimed that it found serious violations in the activities of the RTS, which could conceivably lead to revocation of its license. The RTS is the second largest exchange in Russia. The accusations arose after analyzing the exchange's foruth quarter reports in which the RTS failed to separate indirect deals (i.e., arm's-length or market-based transactions) from direct ones (i.e., agreed pricing between two entities, such as private placement or related kinds of transactions). Failure to account properly for these two categories is a violation of Commission regulations. According to the FCSM, the inclusion of direct deals in the calculation of certain trade statistics distorts the real picture by reducing transparency in pricing, leading to increased risks for the investors. The problem is serious; however the FCSM has added to uncertainty in the market by not making a timely decision on how to resolve it. Then, in response to public criticism, it formed a working group in March consisting of representatives from the FCSM, the RTS and the Institute of the Capital Market Development and Management to develop a new methodology aimed at separating direct and indirect deals. However, the FCSM was still not satisfied with the proposed changes to the RTS Resolution "On the order of Information Disclosure." Meanwhile, the Commission promised not to revoke the exchange's license, hoping that the situation would resolve itself soon.

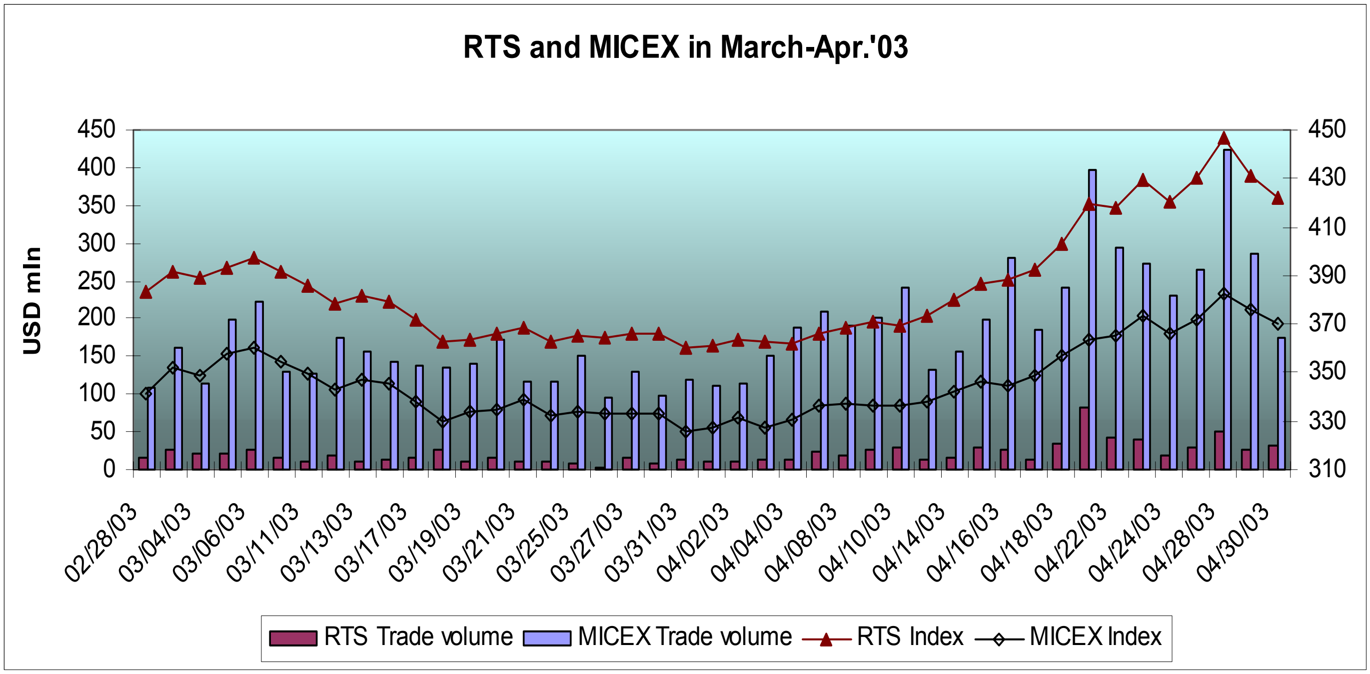
This conflict was a main factor in the resignation of RTS President Ivan Tyryshkin, which raised concerns about the future development of the exchange. Mr. Tyryshkin had brought considerable new dynamism into the RTS' activities, introducing new projects in several segments of the market, including creation of the futures and corporate bonds exchanges, initiation of trade of shares in rubles, and trading shares of Gazprom through the stock exchange "St. Petersburg." However, the newly-appointed acting President Vladimir Streltsov has given assurances that the new team of the exchange will continue these types of policies. As proof, the RTS has announced two new projects, one of which has already been implemented. After a year of development, the RTS has begun a currency trading system called RTS Money, which includes trade in USD tod (price of the dollar with same-day delivery), USD tom (next-day delivery) and USD tom+1 trading, in a test regime. This is the first time a stock exchange in Russia has initiated currency trading after it has already instituted trading in shares, in previous cases the reserve is true. This project will benefit market participants by increasing liquidity in the currency market, and provides another venue for currency trading in Moscow, in addition to MICEX. The second RTS project relates to veksel trading and has been developed together with Gazprombank, which will act as a depository of veksels. The bank will also verify the veksels and will be legally responsible for their legitimacy.

THE RUSSIAN STOCK MARKET IN MARCH-APRIL 2003

In the first half of March, the market exhibited gradual positive movement. The main factors driving the market's upward swing were high oil prices and strong macroeconomic data. Investors were accumulating shares of companies looking for high dividends (Sibneft, Sberbank, RAO UES preferreds, Tatneft, and Rostelecom, among others) and increasing their ownership stakes in order to propose candidates for the BoDs (Mosenergo, for instance). Energo shares were supported by the completion of the second Duma reading of the energy reform bill. The RTS index tested the 400 level in the first week of March but was unable to hold on to it, depressed by profit-taking and then by the impending war in Iraq during the second week of March. Sibneft shares moved in the opposite direction from the market as a result of unexpected news about record high planned dividend payments. The company announced that it plans to pay out $1.09 billion based on the results of 2002, when the total income reported was $1.1 billion. These are the highest dividends ever paid in Russia, beating Sibneft's own previous record of $983 million paid out based on 2001 results. However, the start of hostilities in the Gulf brought oil prices down, depressing profits. The downward pressure on the market continued through the third week of March, brought on by news of sharply falling oil prices. The RTS index consolidated at a level below 370. During the next two weeks, the market fell again due to negative news from world markets as well as the end-of-quarter factor, which forced some players to sell shares.

Starting from the second week of April, however, with the conclusion of hostilities and the announcement of the Yukos-Sibneft merger on April 23, the market experienced an impressive rally, supported by very high volumes. Most observers understood that one of the main forces sustaining this rally was due in part to the "petrodollar" effect. This is the phenomenon of sharply increased ruble liquidity (caused by high oil prices and the government's forced conversion of a portion of oil export revenues into rubles) working their way into the economy -- in particular, chasing too few quality ruble-denominated assets and driving up their prices. On April 28, the index reached its highest level in five and a half years; the last time the RTS index was higher than this level was on October 29, 1997. Oil shares were most in demand during the rally, followed by Sberbank and Mosenergo. However, there was no doubt that the leader was Surgutneftegaz, which played a significant role in bidding up prices.

The rumors were that shareholders were accumulating Surgut shares in an attempt to get control over the company by simultaneously trying to judicially deprive the Treasury stock of the voting rights which belong to management. There was a great deal of murkiness and speculation surrounding the Surgut story in late April, but most stories seemed to clearly fault the company's management, which seemed to be taking the decision to pay dividends to minority shareholders for exactly the wrong reason -- to garner support to block a potential hostile takeover attempt. These moves were not accompanied by an increase in transparency, of the kind that many Surgut shareholders have long demanded; Surgut is the most opaque and least reformed of the major Russian oil companies. But despite the suboptimal fundamentals and bad press, takeover rumors nevertheless fueled demand for Surgut stock on the RTS: a total turnover of $4 billion in three weeks in April led an increase in Surgut's market capitalization from $4.5 billion to $11.6 billion. The tale is widely viewed as a cautionary one, exemplifying the possible pitfalls of investing in the Russian stock market despite the improving macroeconomic situation in Russia and the surging RTS index.



Explanatory notes

ADR - American Depository Receipt

AGM – Annual shareholders' meeting

ARM - Association of Russian Managers

CBR – Central Bank of Russia

DCC - Depository Clearing Company

EGT – Extraordinary Shareholders' meeting

FCSM – Federal Commission on Securities Market

GDR - Global Depository Receipt

ICLG - Institute of Corporate Law and Governance

IPA - Investors' Protection Association

MICEX - Moscow Interbank Currency Exchange

NAUFOR - National Association of the Capital Market Participants

NFA - National Capital Market Association

PARTAD - Professional Association of Registrars, Transfer Agents and Depositories

RTS - Stock Exchange "Russian Trading System"

SGQ - RTS System of Guaranteed Quotes

MMC Norilsk Nickel - Mining &Minerals Company Norilsk Nickel

If you have further questions please contact Maria Golovnia at: golovnyam@state.gov
To view the Moscow Financial Weekly visit http://usembasy.state.gov/moscow/